[JOINT COMMITTEE PRINT]

DESCRIPTION OF S. 1262 (CHURCH AUDIT PROCEDURES ACT OF 1983)

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE

OF THE

COMMITTEE ON FINANCE

ON SEPTEMBER 30, 1983

PREPARED BY THE STAFF

OF THE

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INTRODUCTION

The Subcommittee on Oversight of the Internal Revenue Service of the Senate Committee on Finance has scheduled a public hearing on September 30, 1983, on S. 1262 (Church Audit Procedures Act of 1983), introduced by Senators Grassley, Helms, and East. The bill would provide additional rules relating to IRS procedures for investigating and auditing church books and records.

The first part of the pamphlet is a summary. The second part is a more detailed description of the bill, including present law, issues, explanation of provisions, and effective date.

I. SUMMARY

Present law imposes special restrictions on IRS examination of church records and activities. Under present law, the IRS may examine church books of account (except as indicated) (i.e., financial records) only for certain specified purposes, including the determination of tax-exempt status and the amount (if any) of unrelated business income. In addition, the IRS must provide special advance notice before examining church books of account. Present law also limits examination of church religious activities to the extent necessary to determine whether an organization actually is a church.

The bill would provide several further restrictions on IRS investigation and examination of church records and activities. Under the bill, the IRS would be allowed to investigate an organization claiming to be a church only if it possessed evidence which led it reasonably to believe (1) that the church actually is engaged in taxable activities, or (2) that the organization does not qualify for tax exemption. The IRS would also be required to provide expanded notice before examining church books and records, and to offer church officials an opportunity to meet with the IRS prior to any examination.

The bill would retain the present law restrictions on examination of church religious activities. However, under the bill, the IRS could examine church records of any kind (including books of account and other records) only to the extent necessary to a determination of tax liability. The bill also includes a number of special procedural provisions designed to expedite determinations of church tax liability.

II. DESCRIPTION OF THE BILL

A. Present Law

IRS authority to examine taxpayer records

IRS summons authority

The Internal Revenue Code provides the IRS with authority to examine taxpayer books and records for the purpose of assessing or collecting tax. In addition, the IRS may summon any individual to appear before a revenue agent to give testimony under oath or to produce books and records (Code sec. 7602).

The U.S. Supreme Court has held that, for a summons to be enforceable in a civil tax proceeding, the IRS must demonstrate (1) that the investigation will be conducted pursuant to a legitimate purpose, (2) that the material sought is relevant to this purpose, (3) that the information is not already possessed by the IRS, and (4) that the proper administrative procedures have been followed (*Powell* v. *Commissioner*, 379 U.S. 48 (1964)).

Conduct of examinations

Under present law, the IRS must conduct examinations of taxpayers, and their books and records, in a reasonable manner. The IRS is specifically prohibited from examining a taxpayer's books twice for the same tax year without notifying the taxpayer in writing that such additional examination is necessary (Sec. 7605(b)).

Restrictions on examination of churches

Churches, like other organizations organized and operated exclusively for religious, charitable, or educational purposes, are exempt from Federal income tax (sec. 501(c)(3)). However, exempt organizations, including churches, are subject to tax on income from the conduct of any trade or business which is not substantially related to the organization's exempt purpose (secs. 511-14).

Present law (sec. 7605(c)) imposes certain special restrictions upon IRS examination of churches for the purpose of determining whether a church may be engaged in activities which result in unrelated business taxable income, and for purposes of determining tax-exempt status. These include special restrictions concerning the extent of any examination of church books of account and the notice required to be given in advance of an examination. The law also provides further restrictions on the examination of church religious activities.

Church books of account

Notice requirement

The IRS is prohibited from examining the books of account[1] of a church (including conventions or associations of churches) unless (1) the IRS regional commissioner believes that such examination is necessary, and (2) the regional commissioner so notifies the organization in advance of the examination.

Treasury regulations provide that this notification must be made in writing at least 30 days in advance of the examination. The regulations provide further that the regional commissioner may conclude that an examination is necessary only after reasonable attempts have been made to obtain information by written request and the regional commissioner has determined that the information cannot be fully or satisfactorily obtained in that manner. Treas. Reg. sec. 301.7605-1(c)(2).

Treasury regulations state that the purposes of the restrictions upon examinations concerning unrelated business taxable income are to protect churches from undue interference in their internal financial affairs, and to limit the scope of the examination to matters directly relevant to the existence or amount of such income. Treas. Reg. sec. 301.7605-1(c)(1).

Scope of examination

Present law provides that the books of account of an organization that claims to be a church may be examined only to the extent necessary to determine the amount (if any) of tax. Under Treasury regulations, this may include examinations (1) to determine the initial or continuing qualification of the organization as a tax-exempt entity under section 501(c)(3); (2) to determine whether the organization qualifies to receive tax-deductible contributions; (3) to obtain information for the purpose of determining the tax liability of a recipient of payments (e.g., minister's salaries) from the organization; or (4) to determine the amount of tax, if any, which is to be imposed on the organization. The regulations provide further that, in any examination of a church for the purpose of determining liability for tax on unrelated business income, the church books of account may be examined only to the extent necessary to determine such liability.

In *United States* v. *Dykema*, 666 F.2d 1096, *cert. den.*, 102 S. Ct. 2257, *reh. den.*, 103 S. Ct. 17 (1982), the United States Court of Appeals for the Seventh Circuit held that the limitation to "necessary" examinations of churches applied only to investigations of unrelated business income. The case involved an IRS summons for various church books of account as part of an investigation of the church's tax-exempt status. The court held that the IRS could examine any records relevant and material to a determination of tax-exempt status.

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[1]The IRS has interpreted "books of account" to include accounting and bookkeeping records (including cash books, ledgers, etc.) kept in the regular course of business to provide detailed financial records. Under this interpretation, nonfinancial records (e.g, corporate minute books) and direct evidence of financial transactions (e.g., cancelled checks) may not be protected by the statute. See Internal Revenue Manual Part 7(10)71.22(1); *U.S.* v. *Grayson County State Bank*, 656 F.2d 1070 (5th Cir. 1981), *cert. den.*, 102 S.Ct. 968 (1982).

Religious activities

Present law provides that, when an organization claims to be a church, the religious activities of the organization may be examined only to the extent necessary to determine whether the organization actually is a church. Treasury regulations provide that this includes (1) a determination of the initial or continuing qualification of the organization as a tax-exempt entity; (2) a determination of whether the organization qualifies to receive tax-deductible contributions; and (3) a determination of whether the organization is subject to the provisions of the Code regarding unrelated business taxable income.

Once it has been determined that an organization is a church, no further examination of its religious activities may be made in connection with determining its liability for tax on unrelated business income. Treas. Reg. sec. 301.7605-1(c)(3).

The law does not require the regional commissioner of the IRS to give special notice before examining the religious activities of a church for the purposes described above. However, the IRS administratively had adopted such a procedure (Internal Revenue Manual Part 7(10)71.21(4)).

Statute of limitations

Under the general limitation provision of the Code (sec. 6501), the IRS is required to assess income taxes, or to initiate a proceeding for collection without assessment, within 3 years after the return was filed. Where a taxpayer fails to file a return, the 3-year limitation is inapplicable, and the tax may be assessed at any time. The tax may also be assessed at any time in the case of a false or fraudulent return, or a willful attempt to defeat or evade tax in any manner.

Declaratory judgment actions

Present law (sec. 7428) allows a taxpayer to bring a declaratory judgment action in any case involving a controversy (including an adverse IRS determination or failure to make a determination) with respect to tax-exempt status under section 501(c)(3). The action may be brought in the Tax Court, Claims Court or the United States District Court for the District of Columbia.

The court may issue a declaratory judgment only upon determining that the taxpayer has exhausted administrative remedies available within the IRS. An organization is deemed to have exhausted its administrative remedies if the IRS fails to make a determination within 270 days after the determination was requested and the organization has taken all timely and reasonable steps to secure a determination.

Prohibition of injunction suits

Present law generally prohibits taxpayers from seeking injunctions against assessment or collection of tax.

B. Issues

The principal issue is whether further limitations should be placed on IRS investigation and examination of church activities for the purpose of determining a church's tax-exempt status or the amount (if any) of unrelated business taxable income. Related issues include:

Should the IRS be required to make a special evidentiary determination before commencing an investigation of church activities?

Should the IRS be required to meet with church officials before examining church books and records?

Should any special provisions regarding churches be applicable to all investigations of church activities (including investigations concerning the tax-exempt status of a church), or only to investigations concerning unrelated business taxable income?

Should special notice be required only prior to examination of church books of account, or prior to examination of any church books and records?

Should the procedures for assessing tax against churches (including notice requirements, statute of limitations, and exhaustion of administrative remedies) differ from those with regard to other tax-exempt institutions?

C. Explanation of the Bill

Overview

The bill would allow the IRS to investigate an organization claiming to be a church only if it possessed evidence which led it reasonably to believe that the organization was engaged in taxable activities or did not qualify for tax exemption. The bill would also provide expanded notice requirements before examining any church books and records, including a requirement that church officials have an opportunity to meet with IRS representatives before an examination of church records. The bill would limit examinations of any church books and records to only those necessary to determine tax liability. In addition, the bill would add special procedural provisions designed to expedite the determination of church tax liabilities.

Restrictions on investigation of churches

The bill would prohibit an IRS regional commissioner from commencing any investigation or proceeding to determine whether a church (including a convention or association of churches) was engaged in taxable activities, or whether an organization qualified for tax exemption as a church under section 501(c)(3), unless the regional commissioner possesses evidence which leads him reasonably to believe (1) that the church is actually engaged in taxable activities, or (2) that the organization does not qualify for tax exemption.

Before commencing an investigation or proceeding for these purposes, the IRS would be required to provide written notice to the organization against which the investigation or proceeding is initiated. This notice would be required to include (1) a list of the Code provisions which authorize the investigation or proceeding; (2) an

explanation of the rights of the organization under the Code and under the Constitution (including the right to be represented by legal counsel and the right to challenge any subpoena or other IRS process on legal or constitutional grounds); (3) an explanation of the concerns which gave rise to the investigation and of the relevant legal and factual issues; and (4) a description of all evidence discovered to date. Additionally, the notice would be required to include a specific and clearly worded statement of the facts the IRS "hopes to determine" by means of the investigation or proceeding.

Examination of church records and activities

Concurrence of regional counsel

Under the bill, the IRS could examine church records (including books of account and other records) or church religious activities, for the purpose of any investigation described above, only upon receiving the concurrence of the IRS regional counsel in the proposed examination.

Offer of conference

Prior to submitting a recommendation for examination to the regional counsel, the regional commissioner would be required to notify the organization whose records were to be examined, in writing, that an examination is under consideration. This notice would be required to include a list of the concerns which gave rise to the investigation, the relevant legal and factual issues, and a description of all evidence discovered to date.

The regional commissioner would further be required to offer the organization, in writing, an opportunity to meet with an IRS official to discuss the facts, evidence and issues relating to the investigation. The organization would have 15 days after notification in which to request such a meeting.

Notice of examination

After receiving the concurrence of the regional counsel in the proposed examination, the IRS would be required to notify the organization at least 15 days prior to the examination. This notification would be required to include a description of all church records and activities which the IRS seeks to examine.

Scope of examination

The bill would provide that church records (including books of account and other records) may be examined only to the extent necessary to a determination of tax liability.

The bill would retain the present law rule that the religious activities of any organization claiming to be a church may be examined only to the extent necessary to determine whether the organization actually is a church.

Requirement of IRS determination within one year

Under the bill, in any investigation or proceeding brought against a church, the IRS would be required to make a determination within 365 days after notifying the church of the commence-

ment of the investigation. This period would not run during any judicial proceeding initiated by the church or during any period in which the IRS is unable to make a determination because of the refusal of the church to comply with reasonable requests for information.

Statute of limitations

The bill would require the IRS to to assess any tax against a church both (1) within 3 years after the tax became due, and (2) before the expiration of 3 years after the date on which any part of the tax was paid. The IRS would also be prohibited from bringing a court proceeding for collection without assessment after any part of the tax was paid, or more than 3 years after the tax was due. These limitations would apply regardless of whether the church filed a return for the taxable year in question.

Declaratory judgments

Under the bill, once the IRS notifies an organization that it intends to revoke its status as a church, or that it intends to assess taxes for unrelated business income against the organization, the organization would be deemed to have exhausted its administrative remedies for purposes of the declaratory judgment provision of the Code (sec. 7428). The organization would thus be entitled to bring a declaratory judgment action to preserve its tax-exempt status without awaiting further IRS action.

Injunctive relief

The bill would entitle any organization claiming that the IRS has violated the restrictions on investigation and examination of churches (including the requirement of a determination within one year) to seek an injunction against further violations. Jurisdiction for the suit would be in the United States district courts. If it prevailed in the suit, the organization would be entitled to an award of reasonable attorneys' fees under section 7430 of the Code.

D. Effective Date

The provisions of the bill would be effective with regard to investigations, examinations, and proceedings commencing after the date of enactment.

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